Member - Owned Financial Institutions:
Lessons from Uganda and Tanzania,
1997 - 2004

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Member-owned financial institutions face three challenges: effective internal management of the operations, monitoring and enforcement of loan contracts, and building mutual trust and relationships with the community by offering their member owners value propositions that can meaningfully translate into improved lives. The extent to which they meet these challenges is largely determined by a variety of economic, social, and moral incentives and to a lesser extent by the forms of enforcement and penalties that can be created by such institutions. One major issue is to what extent member ownership by itself can bring about meaningful participation, representation, and sound management. The paper uses two theoretical frameworks namely the Principal - Agent and the Collective Action frameworks. Depositors are the principals and institutions are the agents and therefore issues of information asymmetry, adverse selection, and moral hazard play a major role in understanding and working with such institutions. Collective action issues are related to group size. The larger the group's size, the lesser are the incentives for active member participation and the greater the chances of free riding. What are the selective incentives to bring about proactive participation and oversight by members? What are the financial and non-financial incentives (e.g. social capital) that can bring about improved loan repayments, sound management and good governance? How does external regulation and supervision improve principal-agent and collective action outcomes and therefore the sustainability of such institutions?

Financial Services Associations (FSAs) in Uganda and Tanzania during the 1997 – 2004 period offer an example of such member - owned institutions[2]. The FSA experience shows that such institutions can have low operating costs and benefit from the information inherent in community ties to lower lending costs while they can lend at relatively high rates of interest due to the scarcity of loanable funds and high demand for loans. Successful FSAs were those that could contain expenditure and arrears to a level that would generate a net annual surplus. The high interest income and the relatively low costs (and low arrears) is what enabled the institution to operate and generate the economic incentives for its members, managers, and board of directors to continue working with it. The loan contracts were mostly "self-enforced" because the borrower's main repayment incentive was to preserve their reputation and credit history with the institution so that they could get additional loans. In other words, loan repayment was primarily determined by economic incentives. Formal enforcement of loan contracts through the legal system was expensive and ineffective and almost never used although informal enforcement of loan contracts through local pressure and local institutions played a role in some cases. In other words, legal and social penalties played a much smaller role in loan repayment. Because of proximity and collusion between the managers and some borrowers, FSAs proved in some cases to be more tolerant of loan arrears than other financial institutions that were not member-owned. This also reflected weak social capital and weak trust in the community. Social incentives that can glue the institution and its members together were therefore less available than is commonly assumed. Moreover, emphasis on share ownership did not act as an economic incentive to change member behaviour. This was because of the tiny size and the insignificance of the ownership stakes. Therefore, ownership or profit sharing considerations were far less significant for kost member owners than access to financial services and the value propositions offered by the institution.

Successful FSAs were those with high incomes that could afford to pay an adequate salary to their managers. In FSAs with low incomes and low salaries, local managers were often insufficiently motivated and this lead to management problems and even embezzlement in some cases. Board members also had to be induced by financial incentives to remain interested and smaller boards performed better than large boards because they could get a better remuneration. Although training and supervision proved to be indispensable to FSA operations for correcting mistakes, ensuring financial discipline, monitoring loans, and improving governance, training by itself was not a substitute to inadequate economic incentives.

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[2] - The FSA concept is based on an Article by Ahmad Jazayeri, "Rural Financial Service Associations – the Concept", Small Enterprise Development Journal, June 1996.

Poor linkage with other financial institutions resulting from the information gap between these institutions and the formal financial institutions, impacted negatively on loan repayments, growth, and their role as a financial intermediary. FSAs financed business loans for working capital as well as personal loans especially school fees. Urban-based FSAs performed generally better than remote rural FSAs, achieved a more diversified loan portfolio and better minimized risks to their depositors. In spite of their shortcomings, FSAs had a broad impact in improving the cash flow of local businesses, financing school fees, and improving the public's confidence in financial services.

FSAs in Uganda and Tanzania are member- owned financial institutions (MOFIs) for delivering financial services to the poor and under-banked areas. They were owned by members from the local community and managed through an elected committee that approved loans and oversaw the professional staff. There was a manager, a loan officer, and a cashier full time to run the office. They operated very similarly to credit unions or Savings and Credit Cooperatives (SACCOs) with two differences. The first difference was their emphasis on shares (equity) that gave the members proportional voting rights, capital appreciation, and greater dividend payments. The second difference was that the FSAs were not registered as cooperative societies and therefore could not legally lend out their savings. They had to use their share capital and their own retained earning for issuing loans. Because of the lack of a legal status, they operated as quasi branches or franchisees of a registered company, which also acted as their apex body. These differences have now been removed and the FSAs are now independently registered cooperative societies. An innovative feature of the model was the fee-based relationship between the apex and the FSAs under which they paid a percentage of their monthly revenue for supervision services by the apex.

THE THEORY

The article combines theoretical reasoning and field evidence collected by the author during the 1997 – 2004 period. The theoretical framework is used to illustrate the expected outcomes and possibilities while actual observations are used to validate or discard these possibilities. The framework is based on an analysis of economic and social (including moral) incentives that determine institutional and member behaviour. It combines the concepts of: (a) financial intermediaries as delegated monitors[3], (b) embeddedness of financial transaction and economic behaviour in social relations[4], (c) collective action and problems of groups[5], and (d) contract enforcement[6].

Financial Intermediation as delegated monitoring. Considering the financial intermediation process within a Principal – Agent framework, financial intermediaries are the agents who are delegated the authority to invest in financial assets by their principals who are the depositors and the shareholders. A financial intermediary exists because it is more efficient for depositors to lend their money to an intermediary who can invest it and monitor its use on their behalf rather than doing it directly (Diamond 1993). The intermediary must solve a number of issues that are primarily related to incentives both internally and for the clients: (a) it has to offer value propositions in terms of products and services such as savings and loan in order to collect loanable funds from depositors, (b) it has to offer attractive loan products so as to motivate the borrowers and (c) it has to offer adequate incentives to its own management in order that they: adequately appraise loans, establish relationships with their clients, effectively track and monitor the loans, enforce loan contracts in case of defaults, maintain expenditure at a reasonable level so that they can generate a profit, minimize risks by diversifying their portfolio and prevent insider

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[3] - - Diamond, Douglass. "Financial Intermediaries as Delegated Monitors", Review of economic Studies, 1984, LI, 393 – 414; and "Financial Intermediation as Delegated Monitoring: A Simple Example". Federal Reserve Bank of Richmond *Economic Quarterly* Volume 82/3, Summer 1996.

[4] - Coleman, James S., Foundations of Social Theory, University of Chicago Press, 1990.

[5] - Olson, Mancur, The Logic of Collective Action, Harvard, 1965.

[6] - Greif, Avner., "Contracting, Enforcement and Efficiency: Economics Beyond the Law", Annual World Bank Conference on Development Economics. 1997. Greif only distinguishes between formal and informal enforcement. The latter for him is what I have called self-enforcement. Also, North, Douglass, Institutional Change and Economic Performance, 1990

dealings by the managers and board members who could act opportunistically by using privileged information to their own advantage.

Social Capital. Individual economic behaviour is not only shaped by financial incentives but also by group interest or social relationships that shape what may be called social incentives. Social capital emphasizes the embeddedness of financial transactions and economic behaviour in social relations – in generating trust, in establishing expectations, and in creating and enforcing norms (Coleman 1990, Granovetter 1985). MBFIs need to build social incentives by generating mutual trust and commitment by member owners if they are to extend their services to the wider public and move beyond the narrow bond of family, friends, and relatives. Weak social capital is manifested in a variety of forms including weak commitment by board members, lack of mutual trust between the institutions and its borrowers, and opportunistic behaviour by both the management and the borrowers. Erosion of social capital or social incentives emerge when connections among friends, business associates, or people from the same family or ethnic group results in collusion to promote their own interests to the detriment of the other members or the wider community.

Collective Action. Interests of individual members and the degree of inducements affects member contribution and behaviour (Coleman 1990, Olson 1965) Olson has shown the paradox of collective action in large groups where each member of a group wants other members to make sacrifices while he or she "free rides," reaping the benefits of collective action (the public good) without doing the work. As the group gets larger, free riding increases. Inevitably the end result is that no one does the work and the public good or the common interest is not realized. It cannot be assumed that the group members would act in the interest of the group because the cost of participating in collective action in terms of time and sacrifice may not be compensated by the benefits for the individual member. In such cases, only a separate or "selective incentive" that operates not indiscriminately for the group as a whole but rather selectively towards the individual can contribute towards the provision of public goods. Selective incentives can be positive in the form of inducements or negative in the form of punishments[7]. The tiny ownership rights for each member is therefore not a sufficient selective incentive for them to act in the interest of the group and other direct incentives or penalties are needed to motivate individual participation.

Social capital can minimize "free rides" by making members act for the promotion of the collective interest (public good) without direct economic or financial incentives. Good governance is a public good that is brought about when social capital and selective incentives can overcome free riding.

*Contract Enforcement***.** There are three possible contract enforcement mechanisms that can be used by MBFIs. These are: (a) formal enforcement through the legal system, (b) informal enforcement through the community's local pressure, and (c) self-enforcement that comes about through the prospect of economic and social sanctions and because of general morality. Formal enforcement through the legal system involves the lawyers, the commercial courts, court auctioneers etc and is an expensive, long, and uncertain process. Formal enforcement requires that the law enforcement agents remain objective and not influenced by the other party. Another issue with formal enforcement is that most poor borrowers do not have formal collateral such as land titles. Informal enforcement involves peer pressure, pressure from local councilors, and the informal use of local militias or police. Self-enforcement is brought about through reputation, general morality, and personal trust in social networks. Reputation can make contracts "self-enforcing" because the benefits of living up to the contract exceed the costs and the parties are expected to co-operate since cheating could interrupt the business relationship[8].

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[7] - Olsen, Ibid, p.51.

[8] - North, Douglass, Institutions, Institutional Change and Economic Performance, Cambridge University Press, 1990.

ORIGINAL PROJECT DESIGN

Objectives

1. In Uganda, the objectives of the project was the establishment of a nation-wide network of FSAs and development of a franchise-based system of support to establish the basis for a sustainable and robust system of rural financial intermediation with broad-based geographical and socio-economic outreach. The three-year project aimed at further support to the existing seven FSAs in Masaka and an expansion of the number of FSAs to 41 by March 2004. In Tanzania the objectives were the creation of 5 FSAs in 5 wards (parishes) where PLAN had foster-parenting and community development operations.

Strategy

2. The project strategy was to invest in locally owned member-based organizations known as FSAs. The apex organization would mobilize, establish, train, and supervise the FSAs, which would provide local financial services such as savings and individual loans at a low cost with outreach to the underserved markets and remote areas. The FSAs would raise equity/shares from local members, use inexpensive local human resources for their own management and governance, use locally available information about the borrowers and use the social relations and networks (social capital) to generate the needed trust and cooperation for loan recovery. The critical strategic assumption of the project was that because of the familiarity of the FSAs with their borrowers, information costs and therefore appraisal costs would be lowered while local ownership, trust and peer pressure would lower loan enforcement costs. This strategy was adopted in contrast to other microfinance strategies involving services through centrally managed group-lending NGOs which do not provide from local ownership, likely to have much higher operating costs, and usually do not penetrate rural areas in a significant way.

Assumptions of the original FSA Concept

The key assumption underlying the FSA concept as formulated in 1996 were as follows: (a) shares or equity with a potential for high returns would be an attractive financial investment or most people; (b) funds mobilized through the sale of shares would be sufficient to meet credit needs; (c) local human resources would be available for management and governance requirements and they were considered to require only short-term training to get them ready for the job; (d) because of local ownership and the dense network of social ties, there would be sufficient social capital in the form of mutual obligations, expectations, trust and cooperation amongst the population to minimize cheating and shirking hence enabling effective financial transactions and contracting at a low cost; (e) borrowers would repay the loans because of peer pressure and local ownership considerations combined with respect for contractual obligations; (f) remote rural areas would have a higher level of social capital and solidarity than urban areas and therefore the methodology would have a better chance of success in rural areas.

Initial Setup and Operations

To establish an FSA, a minimum of 100 paid-up shareholders had to make an application to the apex body for support to start mobilization. The apex FSAI would hire the premises, renovate them and install the needed infrastructure including a safe, furniture, computer, motorcycle, and stationery. FSAI would also pay the initial salary of the manager and the cashier for the first three months until the FSA would generate sufficient revenue to pay them.

3. An FSA would raise funds through the sale of shares to members and would re-lend the money to the same members. The principal difference of an FSA with a credit union or SACCO was that although savings accounts were offered to members, such savings could not be lent because FSAs, not being cooperative societies, were not legally allowed to do so. Moreover, in

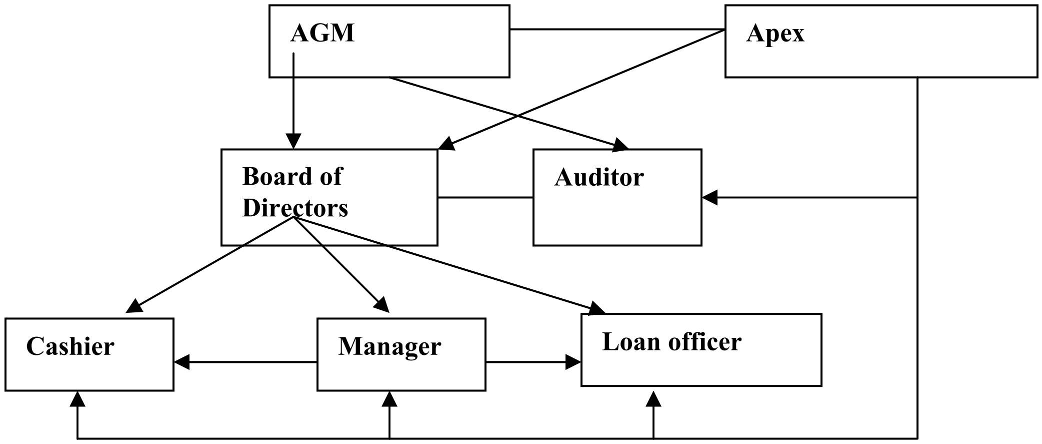
the FSAs shares were an investment that would rise in book value and price as a result of the FSA's financial performance. A key aspect of cooperative law, however, is that it does not allow changes in share price since this would turn the cooperative into a company. The FSAs therefore operated as a hybrid with features borrowed from cooperatives and shareholding companies. To join an FSA, the member would buy a minimum of one share and there would be no limit for the number of shares to be purchased. Shares could be bought at any time from the FSA and they could earn annual dividend according to the date of purchase and FSA's financial results. Share prices could increase each year through increments of retained earnings providing further gain to shareholders. Local shareholders would be the owners of the FSA. Each shareholder would also buy a Savings/Loan Passbook. Savings accounts, principally for safe keeping of cash, would be available free of charge for members.

4. Shareholders could normally borrow up to 3 or 4 times the value of their shares based on their personal net cash flow and locally negotiable security. A single borrower would be allowed to borrow up to 10% of FSA's capital (remember savings could not be used for this purpose). Loan duration was for three months initially and was to be extended gradually to a maximum of one year. Loans could be for any purpose as long as the borrower could provide evidence of his/her repayment capacity or cash flow. Loans would be secured against acceptable locally negotiable collateral worth at least 3 to 4 times the value of the loan. Loans would be made to individual borrowers on a reducing balance basis. The rate of interest on loans (initially at 10% per month on a reducing balance) would be much higher than the bank rates to reflect the local opportunity cost of capital and to allow the FSA to become financially sustainable. The expected operational outcomes were inexpensive financial services (savings, loans, and share investments) that would be made especially attractive because of user ownership and the profit-sharing arrangements.

Governance, Organization, Management, and Human Resources

5. The FSA would operate under a franchise agreement with the apex body that would specify the roles and responsibility of each party. All policies and procedures would be established by the apex body and change from time to time as required by the evolving needs of the FSAs. The boards would be also expected to coordinate shareholder mobilization and loan recovery activities. The General Meeting of the members/shareholders would elect a five-member board of directors namely a Chairperson, a Secretary, and a credit committee. The shareholders would also elect an internal auditor. The board would oversee all governance aspects of the FSA and compliance with standardized policies and procedures as established by the apex body. The credit committee would approve loans. The board would advertise the management positions and appoint a manager and a cashier in consultation with the apex body. The board would be responsible for approving loans and supervising the manager and the cashier. The FSA's professional staff (manager, cashier) would be trained and supervised by the apex body who would have full powers to oversee and adjust all FSA operations.

Organization Chart



Information Technology

6. The project design (in Uganda only) included funding for the development of an in-house software which would be included in the franchise package owned by FSAI. The software would manage all front office transactions and back office accounting operations hence reducing the manager's and cashiers workload. The software would allow for accurate record keeping and accounting and would eliminate the arduous and unreliable manual accounting system that was used by the FSAs during the pilot project. A dedicated programmer would develop and beta test the software before rollout.

Marketing and Competition

7. The project would undertake initial market research through a rapid appraisal prior to establishing an FSA in any location. For marketing and promotion of the FSAs, the project would rely on direct community mobilization through dedicated local mobilizers in collaboration with local government authorities in locations selected for establishing the needed number of FSAs.

8. The project assumed that there would not be significant competition from other providers of microfinance given the many underserved, poor, and remote areas targeted by the FSAs. These were Kampala (Kawempe Division), the Masaka district, and Southwestern Uganda (Ntungamo, Kabale, Kisoro, Rukungiri, Bushenyi, and Kihihi districts). In Tanzania, the areas targeted were the wards covered by PLAN in the Mwanza Region (Buhongwa, Mkuyuni, Mkolani, Igogo, and Sangabuye). The areas in Tanzania were partly served by other microfinance providers but it was thought that the FSA's methodology of individual lending would give it a competitive edge and would appeal to many clients who may be dissatisfied with group loans offered by the other providers.

Linkage with the Financial Sector

Each FSA would have a bank account (current or saving) for depositing their excess cash from shares or savings. They could also use their account for receiving member salaries and depositing them in the member's account at the FSA. They would develop payments products for money transfer through the use of their bank account. The FSA would facilitate access to the money transfer services of banks for their members and would develop life insurance products for their members by linking with a life insurance company.

IMPLEMENTATION AND LESSONS LEARNT

Operations

Shares Price per share varied from USD 2 to USD 8. As at 31 July 2004, FSAs in Uganda had a total paid-up share capital of Ush. 760.4 million (USD 422,000) belonging to 15,383 shareholders representing an average shareholding of Ush. 50,000 (USD 27). In Tanzania share capital was Tsh. 77.5 million (USD 70,400) belonging to 2.325 shareholders with an average shareholding of Tsh. 33,300 (USD 27). These amounts were mobilized locally by the FSAs during the past seven years in Uganda and the past four years in Tanzania. Shares were initially withdrawable but subsequently this rule was changed and shares became non-withdrawable although the FSA could sell member shares on their behalf. The change to non-withdrawability of shares did not result in a noticeable change in the growth of members. About half the FSAs experienced share prices rises of about 20% per year reflecting increases in book value. Share prices never went down however even if the FSAs performed poorly. This was because of the perceived potential psychological impact of declining share prices. A random survey conducted in 2004 amongst 54 shareholders and all FSA staff in 2004 revealed that the principal reasons for people to join the FSA was motivated by access to financial services especially loans and not by equity ownership considerations.

Savings. A savings account was offered once a member bought a share and a passbook. Because of emphasis on shares and the fact that savings could not be legally lent out, the FSAs did not pursue an active savings mobilization policy. Savings were initially limited to 10 times the shares, later they became unrestricted but a commission of 2% was charged on withdrawals, and only towards the end of the project these restrictions were removed. These limitations and charges were designed to restrict the amount of savings per member because the FSAs were not legally entitled to lend deposits and therefore large deposits represented a risk factor. With the recent transformation into cooperative societies, however, this situation has changed and FSAs (now SACCOs) do lend out their savings.

In Uganda, as at 31 July 2004, there were a total of 12,002 savings accounts with a positive balance (78% of all members). Out of these accounts, 5,016 accounts (42%) were active with at least one transaction during the previous seven months while 6,986 accounts (58%) were dormant with no transactions during the previous seven months. On the whole only 33% of all shareholders (1 out of 3) were active users of the savings facilities offered by the FSAs. This shows that for most people the primary motivation for joining was the potential for receiving a loan and not the savings facility. Financial savings were also limited because of the numerous social obligations in family networks and the high opportunity cost of financial savings due to the presence of alternative high yielding trading opportunities.

Loans. Average loan size was USD 74 although the urban FSAs in Uganda did initially issue a few large loans of up to USD 1,500. The usual loan duration was 3 months and loans started from about USD 40 with an upper limit established by shareholding of the individual and the total capital of the FSA. In some cases loan duration was extended to six months and later up to 9 months for larger loans and for agricultural loans. The rate of interest varied between 6% to 10% per month[9]. This was affordable because of high turnover and high margins characteristic of the clients since the amount of interest payable was not a significant percentage of their cash flow.

Each loan was subject to a loan agreement. A shareholder could borrow up to 4 times his/her shares but not more than 10% of the total share capital. As share capital became larger, this ratio was reduced to 5%. In addition to shares, loan appraisal usually included previous credit history, net cash flow from business or employment, and a physical security. Cash flow lending, however, remained an exception rather than the rule. The loans were often made only on the basis of shares and the security offered. Poor book keeping by borrowers and the unreliability of the information played an important part in reducing reliance on cash flow. FSAs accepted securities ranging from formal land titles and vehicle logbooks to informal land purchase agreements certified by the local mayors, chattel items such as household furniture, TVs, radiocasstes,

[9] - In Uganda and Tanzania during the past 5 years the rate of inflation has not exceeded 10% per year.

popcorn machines, and bicycles. In some cases borrowers tried to pledge security already pledged with another microfinance organizations by bribing the local mayors who had to certify for the ownership of the security.

Consolidated FSA Status (Uganda and Tanzania)

Item	**Uganda** **31 July 2004 (34 FSAs)**	**Tanzania** **28 February 2005 (5 FSAs)**
Number of members	15,382	2,325
Total Assets	Ush 926 million (USD 514,000)	Tsh 94 million (USD 85,000)
Net Advances to Customers (after provisions)	762 million (USD 423,000)	Tsh 77 million (USD 70,000)
Savings	Ush 137 million (USD 76,000)	Tsh. 16 million (USD 14,600)
Capital and Reserves	Ush 789 million (USD 438,000)	Tsh. 78 million (USD 71,000)
Average loan size	Ush 134,000 (USD 75)	Tsh 80,000 (USD 73)
Monthly return on loans	4%	6%
Average gross monthly income during the year	Ush 54 million (USD 30,000)	Tsh. 7.2 million (USD 6,500)
Average gross monthly expenses during the year	Ush. 44 million (USD 24,000)	Tsh. 5.6 million (USD 4,900)
Average net monthly income	Ush. 10 million (USD 6,000)	Tsh. 1.4 million (USD 1,200)

Exchange rates: USD 1 = Ush 1800 and Tsh 1100.
Source:Quarterly Reports of FSA International Uganda/Tanzania

Loan impact. FSA loans played a useful role in improving the working capital of small businesses, in reducing distress sales, and improving household liquidity especially for school fees. In a survey of 54 FSA shareholders in 2004, 79% of the respondents said that people trust and respect the FSA since it has helped many people and has re-established trust and cooperation in the community. The survey also revealed that the principal causes for client satisfaction with FSAs in order of importance were: availability of school fee and emergency loans with affordable security conditions, fairness in giving out loans, loans to individuals as opposed to groups, proximity of the FSA to their place of residence or work, low cost of savings accounts, and local ownership and involvement in FSA decision making.

Loan Repayment, Contract Enforcement, and Loan Recovery

As at 31 July 2004 in Uganda, there were a total of 4,931 loan accounts of which 3,729 (75%) were active and 1,202 (25%) had been dormant for the previous 7 months. This means that in Uganda, 1 out of every four loan tended to be in arrears. These aggregate figures however hide substantial performance variations amongst the FSAs since arrears were much lower in some FSAs. Taking the loan arrears of over 90 days as the indicator, loan arrears in Tanzania represent 5% of loans outstanding. Loans did tend to be eventually paid off even with a long delay since the annual loan losses were on average below 10% and in well performing FSAs below 3%. Personal loans did not have a worse repayment record than business loans. The borrower's reputation and his/her need to receive repeat loans remained the principal self-enforcement mechanism for loan repayments in both countries. Mutual trust and general morality also played a role but not a significant one. In a survey of FSA shareholders, 88% of respondents said that people do not trust each other in their area, 75% said that people do not respects contracts and especially loan agreements, and 88% said that FSA performance is very much affected by dishonesty of the shareholders

Better loan repayments in Tanzania than in Uganda is partly explained in terms of the smaller number of FSAs in Tanzania which received more intensive supervision and partly because of stronger informal enforcement in Tanzania through the local militia (sungu sungu). Local militia were used for confiscation of assets and to bring pressure on the borrower to pay although this was not a method that could be relied upon on a regular basis because it generated bad feelings in the community. In Uganda there are no local militias. The local county courts' jurisdiction is limited to Ush. 100,000 or USD 60 and they are not allowed to rule on disputes involving higher amounts. The local police could not get involved in enforcement because loan repayment is a civil issue. Because of jurisdiction, loan repayment cases could only be referred to level I magistrate courts in district centers. To start a court case in Uganda, court fees are USD 100 and lawyers charge a minimum of USD 300. In view of the average loan size, the costs were usually greater than expected direct benefits. The delay for getting a first hearing in district civil courts with jurisdiction in such cases was 6 to 9 months and a judgment could take more than 1 year. Defaulters who know the inefficiencies in the legal system took advantage of this poor legal situation. Judges and prosecutors could also be less than impartial and influenced by financial incentives.

The actual confiscation of assets was not a frequent occurrence and it rarely paid for the costs and the time involved. In rural areas, for example, there is a taboo against purchasing auctioned land belonging to your neighbour. In such cases which happened frequently, out of town buyers had to be called in and the process proved costly and ineffective. In some instances, managers colluded with the borrowers by inflating the value of the security that was discovered only after the borrower defaulted. Sometimes the loan officers or managers accepted generic descriptions of the security pledged and when it came to confiscation, they were re unable to identify the asset pledged. Later a clause was introduced in the loan agreement that if the assets pledged were insufficient, the FSA could take any assets of value belonging to the borrower. This proved difficult to enforce because of the problems with the verification of ownership and the fact that families live together in the same compound and it becomes hard to distinguish the assets belonging to the borrower and those that do not.

Portfolio Diversification

Generally the FSAs achieved a diversified loan portfolio by lending to a variety of businesses and by financing both business and personal loans. Urban FSAs were more diversified than rural FSAs. Rural FSAs also had a much higher percentage of personal loans in their loan portfolio as compared to urban FSAs. A study of 5 urban FSAs revealed that 20% of the number of loans and 15% of the amount of loans outstanding were personal loans which included school fees, advances against salary, house improvements, and hospital bills. Business loans were 80% of the number of loans and 85% of the amount of loans outstanding[10]. Sample rural portfolios revealed that personal loans on average amounted to 30% of the number of loans outstanding and 40% of the amount of loans outstanding. In some rural FSAs school fees could be as high as 60% of the portfolio. Rural business loans were on average 40% for agriculture and the remaining was for services, marketing, and petty trade. Generally in remote FSAs, the portfolio was less diversified and had a greater concentration of agricultural loans and personal loans.

Product Development

Rapid financial assessments revealed that needs are very similar in most locations. People all wanted financial services and they all needed savings, loans and transfer services. There was also a distinct request in favour of accounts that would not allow instant withdrawal such as fixed

[10] - The businesses were: roadside petty vendors, supermarkets, electronic shops, auto spares, pharmacies, tailors, butchers, hairdressers, fruit and vegetable vendors, clothing shops, video cinemas, boda boda purchases (motorcycle taxis), taxi operations, fish mongers, timber sellers, beverage vendors, matoke (cooking bananas) wholesalers, furniture makers, phone shops, charcoal sellers, contractors, produce buyers, travel agents, small scale farming, restaurants and bars.

deposits[11]. In terms of loans, it was discovered that people prefer monthly to weekly payments, they prefer individual loans to group loans, and they prefer longer terms (over 6 months) to shorter terms (3 to 6 months) for loan repayments. Due to insufficient loanable funds to enable the FSA to lend long term and the legal framework that did not allow them to lend deposits, some of these products could not be offered. For example, fixed deposits had to be re-deposited in banks involving considerable transport costs and risks making them unprofitable.

Human Resources and Training

Uganda. A staff qualification survey of all managers, cashiers, and auditors in Uganda (132 individuals) revealed that 8.3% had a Bachelors degree, 65% were diploma holders, and 26% held an A-level certificate. FSAs often experienced difficulty in finding or recruiting educated individuals with a degree or a diploma. Even people with the degree or diploma did not have the practical skills of management or accounting and had to be given fresh training.

Tanzania. A similar survey of the management qualification levels in Tanzania revealed them to be generally less qualified than in Uganda. There were no managers with a university degree and they mostly had O-levels with a small number of A-levels or diplomas. Board members generally had only O-levels or primary education and only one had a university degree, one had a diploma, and one an A-level. These human resources were generally the best that could be found in these locations.

Training. Training for managers, cashiers, and management committee members was carried out several times. The first training for managers consisted of a two-day classroom training by the apex body followed by two to three days of shadowing in another FSA. Follow-up and refresher training was carried out two to three times per year through workshops and seminars. In Uganda all managers, loan officers, and auditors were required to attend a course in microfinance and they all received a certificate from an accredited institution. Supervisors gave hands-on training by correcting mistakes and errors during their bi-monthly visits. Management committee members received a two-day training when they were elected followed-up by 2 to 3 workshops each year. Supervisors from the apex body participated with the management committee to ensure that the committee members had a sound understanding of the principles, policies, and procedures for governance and credit appraisal.

Governance

Board performance in terms of frequency of meetings, quality of discussions, and the effectiveness of oversight varied from excellent to very poor. Board members were elected by shareholders on grounds of being trusted and or having played a leadership role in the community. This however did not guarantee their qualification, competence, or even honesty. Most did not have higher educational levels. Extensive basic training in local language was needed for achieving a minimum level of understanding of operations and oversight. In spite of these shortcomings, however, there were many board members who proved to be committed and performed well.

An area where constant oversight was needed was insider dealings by board members. At times the chairman or another committee members tried to take advantage of their office and force the manager to issue loans to friends, relatives or political alliances. The apex had to play a monitoring role in safeguarding the professional independence of the manager vis-à-vis the board members. A monthly allowance was paid to board members. Due to low remuneration of board members and limited resources, halfway through the project, the apex body introduced a policy of reducing the number of board members from five to three and increased board member allowance so that they could be better motivated and participate more actively. This policy proved effective in most cases where the remaining board members, renamed as Management Committee (MC),

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[11] - The same conclusion was drawn by Bakeine, Amos S.N., "An analysis of factors affecting the demand for services by rural savers in Uganda: A Case Study of Kibaale District (July 2001).

played a more active governance role. This may be a lesson for the other MBFIs where there may be too many ineffective board members and the active one are poorly compensated for the their contributions. The same policy was also introduced in Tanzania with a similar positive impact.

Generally FSAs with a small volume of business had poorer leadership. Very remote FSAs had the worst governance because of poor qualifications of the board and their limited interest. The quality of governance in richer urban FSAs or larger rural FSAs improved with their size. The small institutions were too small to generate financial incentives and too big to rely on the logic of small groups for internal governance. Elected political officials were usually not good FSA leaders. Sooner or later their position of control and influence was abused for political ends especially at election time. This led to a policy of not allowing elected political officials to become board members.

Although nominally the owners, members showed limited ownership interest and often played a marginal role in actual decision-making. Member participation in Annual general meetings (AGMs) was generally unsatisfactory and did not exceed 25%. In some cases AGMs had to be held with only 20% or less of members present. The situation was worst in remote rural FSAs and better in urban FSAs. The experience with member participation confirms to a large extent Olson's theory of free riding and selective incentives. Those who turned up were mostly large savers, large borrowers, and the defaulters who wanted to see what policies are being pursued for loan recovery. The majority of members who are those with small shares and small occasional loans were mostly free riders that did not spend the needed time and effort to participate in elections and decision-making. Members who came to the meetings because of social capital and public interest were generally the minority. Some came just to have a free lunch and a soda, meet other people, or just out of curiosity. This confirms the point that ownership of a share may not provide sufficient incentives for member participation and other non-financial incentives including client education can contribute to this end.

Supervision

Internal Audit. Internal audit by the FSA's own internal auditors remained a significant weakness. The FSAs had an audit committee elected by the AGM. This proved ineffective for a number of reasons. First, the individuals elected during an AGM did not have the needed qualifications and it proved very difficult to train them in accounting concepts and audit methods. Second, because they were originally a committee of three, it proved difficult to provide a motivating allowance to these auditors given the low-income levels of the FSA. Third, elected auditors were often related by ethnic group or neighborhood to the managers or board members and proved weak or ineffective. To remedy this situation, the apex body selected the best auditor among the three in each FSA, increased their allowance, provided them with fresh training, and required a monthly report. These measures improved the effectiveness of internal audit in terms of weekly cash controls and follow-up on loan repayments. Generally, the internal auditors were unable to provide the needed independence and competence to replace the external supervisors and could not be entrusted to solely supervise the institution. The shareholders also did not trust internal auditors as being solely in charge of supervision.

External Supervision. The managers and management teams needed six forms of assistance. First, they needed someone to correct their mistakes. Second, they needed training in record keeping and accounting, lending policy, organization, and end-year closing of their books. Third, the organization often did not provide the right incentives for the managers to do their job properly at all times and there was need for an external overseer to ensure that managers are properly paid and are able to do their job with professional independence. Fourth, the FSAs needed external cash control on a regular basis to prevent embezzlement. Fifth, they needed a regular monitoring to follow-up on all loan without exception or selection. Six, they needed a mechanism to credibly communicate to their shareholders and depositors about the safety of funds and the performance of the business. External supervision aimed to satisfy all these requirements. Supervision was carried out twice per month by the apex body that also organized training workshop, stationery, IT systems, and participated in AGMs. Supervisors followed a supervision checklist, which included the verification of vouchers and entries, verification and adequacy of loan appraisal, consistency of the follow-up on loan repayments, monitoring of loan tracking and aging reports, checking stationery use, and reviewing management committee minutes. Stationery was provided by the apex body and was fully paid for by FSAs after their first six-months of operations. Average local supervision costs for an FSA amounted to about USD 200 per month.

Financial Management. FSA's principal income was from interest on loans and to a lesser extent from the sale of stationery and fees. The minimum level of expenditure for an FSA was about USD 400 per month, which was needed for the bare minimums of rent, salaries, and operating costs. Expenses increased as operations expanded. The average monthly expenditure of an average FSA was 5.8% of the loans outstanding or about Ush.1 million (USD 600) per month for a loan portfolio of Ush.18 million (USD 10,000). This cost per loan ratio is lower than most NGOs in Uganda whose monthly expenditure can be as high as 25% of their loan portfolio. In terms of profitability, they spent 80% of their income on average. Expenditure gradually declined as a percentage of income to about 50% and stabilized at that level. Expenditure levels were fixed on the basis of their quarterly income, staff motivation, and a small surplus for the institution. The managers did not always follow the agreed upon budget and over-expenditure did occur. One key supervisory role for the apex body was expenditure monitoring. Liquidity management for meeting savings withdrawal obligations was not an issue since savings were not lent. The bookkeeping was initially done manually based on a one-book system with a running cash balance on the left side and the debit/credit columns for various accounts on the right side.

Computerization. In Uganda, a total of 28 FSAs became computerized and used the software developed by the apex body. The principal limitation was the irregularity of electric power. The software was learned quickly by the managers and cashiers and become a useful tool for financial reporting, loan tracking, and monitoring of client accounts. Computerization increased the available time to the managers for spending more time on loan follow-up and less time on updating ledgers and preparing accounts.

*Embezzlements***.** There were 7 cases of embezzlement in Uganda during the 2001 – 2004 period and 2 cases of embezzlement in Tanzania. In 7 out of 9 cases, the managers were solely responsible. In other cases, both manager and cashier were involved. In one case in Tanzania, even the internal auditor was also involved. The money stolen was rarely recoverable because the managers or cashiers usually invested the money in a speculative venture and usually resulted in the money being lost. None of the embezzlers were properly prosecuted except for brief detentions (maximum 4 months). This was due to the slow and sometimes often corrupt legal system that is currently in place in Uganda. Supervision played an important role in detecting and stopping embezzlements. Even with supervision, however, embezzlements did occur since supervisors visited the premises only twice a month.

Linkages with the Financial Sector

All FSAs operated a savings or a current account at a bank nearest to their operations. They also paid a monthly premium for their borrowers to a life insurance program (an insurance linkage). Neither in Uganda nor in Tanzania however did bank linkage result in refinancing of loans (except in one case for an isolated loan in Tanzania secured by a shareholder's house). The absence of linkage for refinancing was a severely limiting factor and slowed growth significantly in many cases. This also led to credit rationing and de-motivated many members. To secure a loan or a line of credit from a bank, the FSAs needed to provide a physical security that they didn't have. Banks could not accept the loan portfolio or cash flow as sufficient security for issuing loans. There was also a major information gap in terms of understanding the true potential and constraints of the FSAs and other SACCOs that are perceived as too risky by the banks (and other MFIs). This constitutes a continuing obstacle for improved linkages between the formal and the informal financial institutions.

Performance Ranking

The FSAs in Uganda were ranked as 24% excellent, 29% good, 14% fair, 18% poor, and 15% very poor (near closure). In Tanzania they were 20% excellent, 40% good, 20% fair, 20% poor, 0% very poor. The assessment was based on their monthly revenue, arrears, management performance, incidence of fraud, and growth prospects. In other words, in Uganda 53% of FSAs were in the Good and Excellent category while 32% were in the Fair and Poor category while in Tanzania 60% were in excellent and good category and 40% were in fair and poor category. The fair and poor FSAs also received the same level of support and supervision but poor incentives, bad governance, low credit culture, and overall weak social incentives overshadowed their performance.

Lessons Learnt

Lesson 1. The most important determinant of performance is the ability of the member-owned financial institution to offer economic incentives first to the majority of its own staff and then to its members for committing to the institution. Social incentives play an important although secondary role in this regard.

Lesson 2. To offer the needed economic incentives, the institution must generate a minimum volume of business to generate the needed income. In this regard good business locations perform better while remote areas often perform poorly.

Lesson 3. Funds mobilized through the sale of shares were not sufficient to meet credit needs. Most FSAs, with or without arrears, continuously complained of the shortage of loanable funds. Net borrowers outnumbered net savers by 2 to 1. Therefore credit rationing was usually in effect and this de-motivated those members that could not access loans.

Lesson 4. Local human resources were not easily available for meeting the management and governance requirements and needed a significant amount of training. It was generally difficult to find financially competent individuals as internal auditors or as board members.

Lesson 5. There was an inverse relationship between the size of boards and their performance. The smaller boards generally performed better and were better motivated and remunerated.

Lesson 6. Local ownership and local social ties did not always provide the needed social incentives in the form of trust and cooperation between the institution and the members.

*Lesson 7. S*elf-enforcement of contracts because of reputation and credit history were the main incentives for loan repayments.

Lesson 8. Ownership interests and profit sharing provided an incentive to only a minority of larger shareholders but was not a major factor for most members for joining or staying in the FSA. Ownership considerations also proved secondary and sometimes irrelevant in terms of loan repayment because of the insignificance of the individual shareholdings.

Lesson 9. FSA borrowers were willing to pay a high interest rate on loans. Surveys showed that interest payments usually represented a small percentage of their cash flow. Over time the income from interest payments covered intermediation costs, risk premiums, and the needed financial incentives.

Lesson 10. The relationship between the FSA and its borrowers together with loan monitoring enabled the FSAs to make concessions in terms of grace periods and interest-only payments hence reducing the need for liquidation of borrower assets for loan recovery. Arrears declined with older loans and loan losses were generally less than 10% and lower than 3% for well performing FSAs.

Lesson 11. Formal enforcement through the legal system was almost never used because of the expensive, slow and sometimes corrupt legal process.

Lesson 12. Informal enforcement methods such as peer pressure or pressure from the local mayors or the local militias were only partially effective and generated a bad image of the institution and could not be used frequently.

Lesson 13. External supervision of the FSAs by the apex body was accepted and demanded by the shareholders. External supervision of financial management and governance played an important part in minimizing agency risks and improving performance.

Lesson 14. Bout 2 out of three FSAs proved effective in improving the cash flow of local businesses and the liquidity of households, reduced reliance on distress asset sales by the borrowers and improved incomes.

